

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking to Establish  
Policies and Cost Recovery Mechanisms for  
Generation Procurement and Renewable  
Resource Development.

Rulemaking 01-10-024  
(Filed October 25, 2001)

**ADMINISTRATIVE LAW JUDGE'S RULING CIRCULATING  
SUGGESTED REVISIONS TO PROPOSED DECISION/ALTERNATE  
PROPOSED DECISION FOR COMMENT**

**SUMMARY**

In comments filed April 26, 2004, by San Diego Gas & Electric Company (SDG&E), the utility argues that the proposed decision (PD) that did not adopt the cost recovery, ratemaking and revenue proposals advanced by the utility, was factually and legally incorrect because it assumed that SDG&E had adequate assurance of cost recovery through distribution cost recovery principles. After further consideration of all the comments and reply comments filed by parties, the Commission is weighing carefully whether the requested revisions on cost recovery and ratemaking should be made to the PD, or possibly to one of the alternate PDs (APD). This Administrative Law Judge ruling circulates the suggested revisions and invites comments by Friday, June 4, 2004.

**DISCUSSION**

In its comments to the PD, SDG&E argued forcefully that in regards to the Ramco and Palomar turn-key generation investments, the fact that the PD did

not give any assurances of cost recovery put the utility at “extraordinary and monumental risk for full recovery of its reasonable costs of acquiring and operating the new generation facilities.” The suggested revisions, attached to this ruling as Attachment A, address some of SDG&E’s concerns. SDG&E’s cost recovery arguments are part of the record in this proceeding, and parties already had an opportunity to remark on SDG&E’s comments in their reply briefs. And since the Commissioner Peevey APD did adopt SDG&E’s cost recovery, ratemaking, and revenue requirement proposals, most of this language has already been in the public domain. Therefore, these attached revisions do not meet the definition of an alternate, and we are not required by Senate Bill (SB) 779<sup>1</sup> to circulate them for more comments. However, in light of the fact that there currently are three potential decisions [one PD and two APDs] making the rounds, and compromises and accommodations might be made to reach some consensus at the Commission, we wanted parties to have an opportunity to comment on these revisions concerning the Ramco and Palomar generation investments in case they appeared in a final decision other than the Commissioner Peevey APD.

Parties are therefore invited to file and serve comments by close of business on Friday, June 4, 2004. Only one round of comments will be accepted and documents are limited to ten pages. Electronic service protocols should be followed.

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<sup>1</sup> Decision (D.) 00-01-053, in Rulemaking (R.) 99-02-001, established rules and procedures for Commission compliance with SB 779. Pursuant to that decision, these proposed revisions do not constitute an alternate, do not have to circulate in the public domain, and parties do not have to be given an opportunity to comment.

**IT IS RULED** that parties wishing to file comments to the attached proposed revisions to a Commission final decision in Rulemaking 01-10-024, may do so by close of business on Friday, June 4, 2004.

Dated May 27, 2004, at San Francisco, California.

/s/ CAROL A. BROWN

Carol A. Brown  
Administrative Law Judge

## **ATTACHMENT A**

### **Cost Recovery and Ratemaking Mechanisms**

San Diego Gas and Electric Company (SDG&E) proposes that it be compensated for the general risks inherent in the ownership and operation of major generation facilities through a return on the generation investment that is set at a basis point premium over SDG&E's adopted return on equity for distribution rate base. SDG&E justifies this request for an additur on the basis that there is uncertainty surrounding state and federal energy policy, a lack of legislative direction on recovery of investment in generation assets, and uncertainty of the stability of the future retail customer base. Specifically, SDG&E argues that the future of its customer base will be affected by movements in the areas of direct access, community aggregators, municipalization, and core and non-core. The uncertainty surrounding the ever-changing energy environment makes investment in generation risky -- and SDG&E suggest that a basis point premium mitigates that risk.

SDG&E further requests that the Commission adopt a cost recovery and generation ratemaking plan for SDG&E's investment in the Ramco and Palomar facilities that is separate from distribution ratemaking. SDG&E's plan includes the following elements:

1. Adoption of the initial revenue requirements that can be recovered by SDG&E simultaneously with approval of the Ramco and Palomar projects;
2. Adoption of revenue requirement update rules and a ratemaking process that will govern cost recovery for the ten-year period (2005-2014) of the generation rate plan; and

3. A determination by the Commission that the adopted rate plan should remain unaltered over the ten-year period.

SDG&E's proposed ten-year generation ratemaking plan is divided into three phases. The first phase will begin from the first in-service date through the first full year of operations; the second phase will be in place for the first three full years of operation; and the third phase will start with a test year 2010 generation cost of service (GCOS) review followed by four attrition years. Following the period of this generation ratemaking plan (2005-2014), SDG&E or other parties can propose ratemaking treatment for the generation assets consistent with then existing Commission policy for cost recovery for the remaining life of the generation assets.

SDG&E proposes to use its Non-Fuel Generation Balancing Account to recover the capital and Operation and Maintenance (O&M) costs associated with the Palomar and Ramco plants, while fuel costs for the plants would be recovered through the Energy Resource Recovery Account. SDG&E identifies the first year proposed generation revenue requirements for Ramco, estimated at \$0.5 million per month, and Palomar, estimated at \$8.6 million per month.<sup>2</sup> Subject to adjustments for escalation factors, incentives and possible changes to inputs, these estimated revenue requirements would determine SDG&E's costs to be recovered in rates until the GCOS in 2010.

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<sup>2</sup> SDG&E/Van Lierop, Ex. RFP-87. These estimates are based on SDG&E's proposed Return On Equity of 11.65%, and should be adjusted to reflect the final adopted ROE conditions, as well as any adjustments to cost of capital that may occur before the plant goes into service.

SDG&E also proposes to file advice letters before the plants go into service detailing the costs to be recovered, including adjustments such as incentives, financing costs, and any changes to inputs. In addition, the revenue requirements include expected values for the O&M costs. After the first full year of operation, in the second phase of SDG&E's proposed rate plan, SDG&E will make an annual filing to incorporate attrition adjustments and to amortize any undercollection or overcollection in recorded generation revenues relative to the authorized level.

SDG&E asks the Commission to adopt the initial revenue requirements for these facilities simultaneously with approval of the new investments, so the utility is ensured of recovering all reasonable costs without hindsight review. SDG&E's estimated revenue requirement for Palomar also includes the estimated cost of the equity buildup. The final costs of the equity buildup would be reflected in the advice letter filings under the rate plan.

Another key component of SDG&E's ratemaking proposal for Ramco and Palomar is a 75 basis point premium over its authorized distribution ROE for its ROE on generation investments. The current ROE for distribution is 10.90%, and with the added basis points, SDG&E is requesting a ROE for generation of 11.65%. SDG&E argues that it should not have to wait till the next cost of capital proceeding to address the appropriate ROE for its proposed generation investments because: the utility is entitled to a fair return; generation is riskier than distribution; Ramco and Palomar are large investments for SDG&E (approximately 25% of the utility's existing rate base); and it is important for the financial community to know that the Commission appreciates the risks associated with generation investments.

## **Conclusion**

We find that the Ramco combustion turbine acquisition is supported by the record and approve this turn-key approach. We approve the terms and conditions in the Term Sheet attached to Exhibit RFP-19 and we will approve it when it is submitted to the Commission.

We also approve certain of the cost recovery, ratemaking, and revenue requirement proposals that were requested by SDG&E. Specifically, we approve: (1) SDG&E's proposed initial revenue requirements that can be recovered simultaneously with approval of the Ramco and Palomar projects; (2) SDG&E's proposed revenue requirement update rules and a ratemaking process that will govern cost recovery for the ten-year period (2005-2014) of the generation rate plan; and (3) SDG&E's request that this rate plan should remain unaltered over a ten-year period.

We approve these proposed cost recovery and ratemaking proposals in light of a number of policy considerations. Ramco and Palomar are SDG&E's first investments in new generation in many years; the Legislature and this Commission are considering new policies in the areas of direct access, community aggregators, municipalization, and core/non-core classifications for electric customers that potentially could alter the utility's customer base; and SDG&E, and the other IOUs, argue that there is substantial risk in investment in generation assets as compared with distribution facilities.

However, in addition to the cost recovery and ratemaking elements of SDG&E's proposal that we are adopting today, SDG&E also requests a premium adder to its approved ROE due to the increased risk of generation ownership, as compared with distribution. We do not find this proceeding to be the appropriate forum for changing the ROE, and without making any findings as to

whether the requested premium adder is appropriate, we defer the issue to the next round of cost of capital proceedings.<sup>3</sup> We agree with The Utility Reform Network/Utility Consumers Action Network (TURN/UCAN), Office of Ratepayer Advocates, and others that addressing a return on equity is more appropriate in a proceeding dedicated to the consideration of the complex issues associated with the establishment of all elements of the cost of capital. Therefore, until addressed further by the Commission, the ROE for Ramco will be 10.90%.

In fact, TURN/UCAN and others also raised concerns about the potential of stranded costs for the Ramco and Palomar generation investments if there are future changes to the retail market structure. To address this significant issue of concern to so many stakeholders, the rate plan we adopt today includes a mechanism similar to the one we adopted in the Edison/Mountainview decision, D.03-12-059 whereby all customers of SDG&E that are currently ineligible for direct access are obligated to pay for the stranded costs of any new generation for the next ten years. This will insure that neither the utility, nor its bundled customers, will be forced to pay stranded costs for these generation assets in the event that new direct access is permitted. SDG&E has indicated that it will finance the purchase of the Ramco and Palomar generation assets using debt, equity and preferred stock in proportions matching its CPUC-authorized capital

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<sup>3</sup> Because the issue of premium adders for new utility-owned generation assets, as well as the issue of the alleged need for utilities to receive equity adjustments to recognize the debt equivalence of long-term power purchase agreements, is likely to be addressed in cost of capital proceedings for the Southern California Edison Company as well as for PG&E that will be taking place in 2005, SDG&E is encouraged to participate in those proceedings to the extent that SDG&E seeks resolution of the cost-of-capital issues raised in this proceeding that we have determined to defer.



structure. However, SDG&E has also indicated that its financing plan requires relatively more equity prior to purchase. SDG&E's specific plans are to:

(1) maintain its current bank credit facility to assure liquidity for payment obligations; (2) retain earnings during construction so that SDG&E will have sufficient cash and equity both to pay for the plants and to maintain SDG&E's capital structure at the authorized level when the plants are purchased; and (3) add long-term debt and preferred stock near to the date when the plants are acquired to help pay the purchase price and/or refinance any borrowings under the credit facility that were needed to pay for the power plants.<sup>4</sup>

SDG&E has indicated that its financing strategy for these turnkey projects is very similar to the strategy it would follow if SDG&E were to build the plants itself. The primary financial and credit characteristics of a major capital project are nearly identical, although the payment for a turnkey project is due in a lump sum at completion rather than during the course of construction. In either case, the financing must be completed in advance of any payment date, and increasing amounts of equity should be available as construction proceeds to maintain credit fundamentals.<sup>5</sup>

If SDG&E were building the projects, project costs would be held in Construction Work in Progress (CWIP) and financing costs would be offset through AFUDC earnings. However, under the two turnkey proposals, equity will be retained and dedicated to the projects, but there will be no AFUDC earnings to offset the financing costs. SDG&E has accordingly requested

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<sup>4</sup> SDG&E/McMonagle, Ex. RFP-24 at 6.

<sup>5</sup> *Id.* at 7.

reimbursement for its financing costs while the facilities are under construction, because it is prudent to accumulate equity (and debt) in advance of the payment dates to maintain credit standards and to assure that payments can be made when due.<sup>6</sup> We agree with SDG&E that a regulatory asset should be established for this purpose in the same way that AFUDC covers financing costs for CWIP investments. This regulatory asset will accumulate the cost of equity that is held to pay project costs under the turnkey contracts, and it will become part of the cost of the generation facilities when the power plants are purchased. These amounts will be recovered through depreciation over the plant's lifetime like other project costs. However, the value in this account should be limited such that total capitalized financing costs (both at SDG&E and at the project) will not exceed the amount of AFUDC that would have applied had SDG&E built the facility.

We disagree with TURN/UCAN's position that the Commission should not consider issues related to recovery of the acquisition financing costs until after SDG&E purchases the assets in question. TURN/UCAN does not contest the premise that SDG&E needs to have funds available to purchase the Palomar and Ramco facilities, or that the costs associated with those funds should be reimbursed.<sup>7</sup> We shall therefore approve SDG&E's request that the costs associated with accumulating the necessary equity to purchase the new Ramco and Palomar generation facilities should be allowed.

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<sup>6</sup> *Id.*

<sup>7</sup> UCAN/TURN/Woodruff, Ex. RFP-59 at 47.

***Palomar***

For the same reasons as for the Ramco proposal, we approve certain of the cost recovery, ratemaking and revenue requirement proposals that SDG&E requested for Palomar, including the establishment of a regulatory asset to recover SDG&E's reasonable costs of accumulating the equity necessary to purchase the Palomar facility, and the revenue requirements and the ratemaking plan that SDG&E proposed for Palomar in Exhibits RFP-86 and RFP-87.

**(End of Attachment A)**

**CERTIFICATE OF SERVICE**

I certify that I have by mail, and by electronic mail to the parties to which an electronic mail address has been provided, this day served a true copy of the original attached Administrative Law Judge's Ruling Circulating Suggested Revisions To Proposed Decision/Alternate Proposed Decision For Comment on all parties of record in this proceeding or their attorneys of record.

Dated May 27, 2004, at San Francisco, California.

/s/ ELIZABETH LEWIS  
Elizabeth Lewis

**N O T I C E**

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